WARRINGTON
ASSET MANAGEMENT

July 2012 Market Commentary

"The Stimulus Fallacy" - this could be the best way to describe the reasons behind the stock market's behavior in July. As the market weakened due to increasingly downbeat economic data, further deterioration of corporate revenues (profits have held up due to cost cutting, a short-lived fix but revenues have been weaker than expected) and the ever-present European woes, the higher hopes became for aggressive central bank action. The market, being the discounting mechanism that it purportedly is, saw this weakness as portending immanent central bank action (be it QE3, LTRO3, or some new acronym that has yet to be coined) and so markets rallied on bad news. This "jawboning" tactic of the Fed and ECB had its intended effect: to drive markets higher based on the notion that central banks may act in the near future due to economic weakness. The irony is that due to the market rallying (and bond spreads tightening, etc.) in anticipation of central bank action, then that very action becomes unnecessary. Basically, the market has done the work for the Fed. Eventually, if central banks do not deliver the expected stimulus (or deliver a neutered version of what was expected), markets could get a very nasty wake-up call.

This situation resulted in the market selling off aggressively for a few days then reversing course and trading higher for a few days on rumors of central bank intervention. There were six separate instances of this directional trading since the middle of June, keeping the S&P futures in a range between 1380 and 1300. Warrington held profitable ratio put spreads as the market was declining, but as expiration week approached the market rallied aggressively. This severely reduced the value of the fund's positions, causing performance to essentially be unchanged for the month of July.